GOODWIN PROCTER

REHEARING PETITION DRAMATIZES SECOND CIRCUIT'S COMITY REJECTION[1]

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Recognition of a foreign main proceeding under Chapter 15 of the Bankruptcy Code has "effects" under Section 1520 that are automatic and powerful, including application of the automatic stay of Section 362 and the complementary adequate protection requirements of Section 361. In addition, Section 363 – use, sale and lease of property – applies "to a transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that the [section] would apply to property of an estate."[2] While the legislative history of Section 1520 elaborates on the benefits of allowing a foreign representative to operate a debtor's business in the ordinary course under Section 363(c), it says nothing about the standards to be applied to sales outside the ordinary course under Section 363(b).[3] If a sale has been approved in a foreign main proceeding, is the foreign court approval entitled to comity or must the bankruptcy court apply the standards applicable in domestic cases?

The United States Court of Appeals for the Second Circuit, in *Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, No. 13-3000, 2014 WL 4783370 (2d Cir. Sept. 26, 2014) (*"Fairfield"*) held that, in the context of a Chapter 15 ancillary bankruptcy proceeding, a sale of a claim by the liquidator of Fairfield Sentry Limited ("Sentry") invoked Section 363 review under standards developed in Chapter 11 cases, rejecting considerations of comity to the foreign court approval in the foreign main proceeding (the "BVI Court") after a three day hearing. This decision – which would require U.S Bankruptcy Court oversight and review of any sales of assets meeting the U.S. territorial prerequisite, even where a sale is intimately tied to a foreign main proceeding and has previously been approved by the court in that foreign main proceeding – has the potential to upset decades of Chapter 15 jurisprudence and greatly increase the uncertainty and costs associated with any Chapter 15 ancillary proceeding in which assets are being sold.

The claims purchaser in *Fairfield*, Farnum Place, LLC ("Farnum") filed a Petition for Panel Rehearing or Rehearing *En Banc* on October 10, 2014 (the "Petition for Rehearing"), arguing, *inter alia*, that the Second Circuit's opinion conflicts with well-established cross-border insolvency law that requires application of comity "in *any* transnational adjudication." According to Farnum, the Second Circuit's ruling that Section 363 review is a mandatory prerequisite to any "transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States" fails to adequately take into account a number of very important factors, including (i) that the United States had very little, if any, practical connection to the sale, (ii) that the BVI Court (with the closest nexus to the sale) had approved the sale after a full and fair hearing, and (iii) most importantly, that the "very aims of Chapter 15" center around the principles of comity, which should be considered in *all* instances absent express statutory language that would command a different result.[4]

Sale of SIPA Claim in Foreign Main Proceeding

At issue in *Fairfield* was Sentry's sale of its allowed SIPA Claim in the Bernard L. Madoff Investment Securities LLC ("BLMIS") liquidation proceedings to Farnum. The claim was allowed in the BLMIS case, as part of a complicated settlement between Krys and the Trustee, in the amount of $230 million dollars (the "SIPA Claim"), and was sold

by Sentry, a British Virgin Islands ("BVI") investment fund, in its own liquidation proceedings in the BVI (the "BVI Proceeding" or the "foreign main proceeding") for approximately 32.125% of its total allowed amount. According to the Second Circuit decision, the trade confirmation documenting the sale specifically provided that the sale was conditioned upon approval by both the BVI court and the Bankruptcy Court. As noted below, this "requirement" was not so clear.

Shortly after the sale, the BLMIS trustee (the "Trustee") announced a settlement that would bring approximately $7.2 billion into the BLMIS estate, increasing the value of the SIPA Claim by approximately $40 million. Farnum asked the BVI court to compel Kenneth Krys ("Krys"), the liquidator in Sentry's BVI Proceeding, to complete the sale but Krys, instead, asked the BVI court to disapprove the sale on the basis that it was no longer in the best interest of the Sentry estate. As a foreign main proceeding, the BVI Proceeding would deal with collection and distribution of assets while the U.S. Chapter 15 would provide ancillary assistance.

The BVI court approved the terms and conditions of the sale of the SIPA Claim to Farnum, but did not opine as to whether the Bankruptcy Court (ambiguously – not distinguishing between the Chapter 15 ancillary proceeding and the Madoff SIPA case) would approve the sale under Section 363: "it would be unwise for [it] to express views on the issues that will arise for determination by the U.S. Bankruptcy Court" and the Bankruptcy Court must be "presented with a choice whether or not to approve [the sale]." While the Second Circuit appeared to assume that the trade confirmation embodying the sale contract contemplated approval by the Chapter 15 court, the actual language suggests that approval would be required by the court in the Madoff case.[5]

Bankruptcy Court and District Court Find That Comity Requires Deference to BVI Court Decision Approving Sale

On April 18, 2012, Krys filed an application with the Bankruptcy Court in the Chapter 15 case seeking review of the trade confirmation under 11 U.S.C. § 363(b) and an order disapproving the trade. The Bankruptcy Court denied Krys' application, holding Section 363 did not apply under Section 1520(a)(2) because the sale did "not involve the transfer of an interest in property within the United States" and because, in any event, comity dictated that the Bankruptcy Court defer to the decision by the BVI court.[6] Any decision to the contrary would "necessarily undermine[] the equitable and orderly distribution of a debtor's property by transforming a domestic court into a foreign appellate court where creditors are always afforded the proverbial 'second bite at the apple.'"[7] In other words, the Bankruptcy Court held that principles of comity required it to decline the type of "Section 363 review" that a bankruptcy court would conduct in a Chapter 11 case.

The District Court for the Southern District of New York, on appeal, affirmed the Bankruptcy Court's decision, holding that it was "not clear that Section 363 . . . applies" but that, even if it did, the Bankruptcy Court's decision was appropriate when considering principles of comity.[8]

Second Circuit Holds Comity Does Not Apply

On appeal, the Second Circuit vacated the District Court order affirming the Bankruptcy Court's decision to deny Section 363 review because (i) the sale of the SIPA Claim at issue was a "transfer of an interest of the debtor in property within the territorial jurisdiction of the United States"; and (ii) as a result, Section 363 review was required – without deference to the decision of the court in the BVI Proceeding.

The SIPA Claim Qualifies as Property Within the Territorial Jurisdiction of the United States

As an initial matter, the Second Circuit reversed the Bankruptcy Court and held that the sale of the SIPA Claim was a transfer of an interest of the debtor in property within the territorial jurisdiction of the United States. The phrase "within the territorial jurisdiction of the United States" is defined in Section 1502(8) as including, among other things, "any property subject to attachment or garnishment that may properly be seized or garnished by an action in a Federal or State Court in the United States."[9] The Second Circuit noted that, under applicable New York law, "'any

property which could be assigned or transferred' is subject to attachment and garnishment"[10] and, for attachment purposes, the relevant situs is the location of the party whose legal obligation it is to perform. Because the Trustee has the statutory obligation to "distribute to Sentry its pro rata share of the recovered assets[,]" the Second Circuit held that the situs of the SIPA Claim is the location of the Trustee – New York.

Section 363 Review is Required for any Sale of Assets Meeting Section 1520's Territorial Prerequisite To the Same Extent as it Would be Under Chapter 11

Of perhaps greater consequence is the Second Circuit's decision that, once the territorial prerequisite in Bankruptcy Code Section 1520 has been met, the sale must be reviewed under Section 363 to the same extent as it would be under Chapter 11, without regard to whether principles of comity would require deference to the BVI court's decision to approve the sale. According to the court, where Section 363 review is required, it is "a statutory command" that operates as a "brake or limitation on comity." That the BVI court "expressly declined to rule on whether the Trade Confirmation required approval under section 363" and "it is not apparent at all that the BVI Court even expects or desires deference[,]" supported the Second Circuit's ruling. Because it concluded that the BVI court declined any deference, the Second Circuit did not expressly prohibit a bankruptcy court from affording comity to a foreign court's sale approval – in other words from ruling that the foreign court approval satisfied the substantive aspects of Section 363. But its holding certainly implies that the requirements of Sections 1520 and 363 trump considerations of comity.

The Problems With *Fairfield:* Comity Is No Laughing Matter

The Second Circuit treats the phrase "Section 363 review" as requiring an independent business judgment analysis under its non-Chapter 15 precedent.[11] But applying Section 363 to the same extent that it would apply to property of an estate does not rule out the granting of comity to a foreign court's order.[12] In other words, if the decision of the foreign court would otherwise satisfy the requirements to be afforded comity, it should be considered and accepted by the Bankruptcy Court as satisfying Section 363 to the extent it specifically addresses the sale.

Despite the undeniable fact that principles of comity form the basis for much of Chapter 15 and largely inform its jurisprudence, the Second Circuit, with its decision in *Fairfield* that a bankruptcy court in a Chapter 15 proceeding is *required* to conduct a Chapter 11-like Section 363 review for a sale of U.S. assets regardless of approval in a foreign main proceeding, becomes the second U.S. court to read comity out of the consideration of sales.[13] The Bankruptcy Court for the District of Delaware in *Elpida Memory* was the first, ruling that "Section 1520 is mandatory" and that, with respect to Section 363 review as provided for under that Section, "principles of comity either do not apply or must defer to the plain meaning and legislative history" of the statute.[14]

While there can be no dispute that Section 1520 says that Section 363 applies to sales of property within the territorial jurisdiction of the United States, nothing in Section 1520 suggests that Section 363 should apply to the exclusion of traditional principles of comity or that it cannot be satisfied by a procedurally proper foreign order. When Section 1520 says that Section 363 applies, it merely invokes the procedural requirement for notice and a hearing so that parties affected by a sale of property within the territorial jurisdiction of the United States get notice and an opportunity to be heard. Nothing in the statute requires the same type of 363 review that applies in Chapter 11 cases while Section 1508 and the need to interpret Chapter 15 with a view to its international origin and to harmony with foreign proceedings militate to the contrary.[15] It is without dispute that "Chapter 15 emanates from and was designed around this central concept of comity."[16]

As the Second Circuit held in *Maxwell Commc'ns Corp. v. Societe Generale (In re Maxwell Commc'ns Corp.)*, 93 F.3d 1036, 1048 (2d Cir. 1996) – a seminal pre-Chapter 15 case involving the equivalent of a foreign main proceeding – "deference to foreign insolvency proceedings will, in many cases, facilitate 'equitable, orderly, and systematic' distribution of the debtor's assets." The doctrine of comity, then, must "guide[] our interpretation of statutes that

might otherwise be read to apply to [certain] conduct." To that end, the court in *Maxwell* held that comity must be afforded to any decision by a court in a foreign main proceeding absent specific "contrary legislative direction."[17]

Here, like in *Maxwell*, the words in Section 1520 that make Section 363 applicable to certain sales of assets in a Chapter 15 case are "general words" and, as such, they should not "limit the application of international comity." Notwithstanding its own clear directive in *Maxwell*, the Second Circuit decision in *Fairfield* essentially holds that this general language applying Section 363 overrides the "presumption in favor of international comity." Such a result is inconsistent with the basic tenets of Chapter 15, and contrary to the intentions of its drafters.

Under well-established Chapter 15 jurisprudence, sales such as the one in *Fairfield* should be reviewed under comity principles – considering issues such as fairness and due process to U.S parties – and only if found wanting, should other standards be applied. A Chapter 15 ancillary proceeding is intended to assist the court in the foreign main proceeding; what value creditors will receive and whether a particular sale is appropriate is a function of the main proceeding in which claims will be processed and which will control distributions and should not be a concern of the U.S. court in Chapter 15. The Chapter 15 court's role should be to "cooperate to the maximum extent possible with the foreign court" and to assure that the foreign proceeding "abides by fundamental standards of procedural fairness" and does not "violate the laws or public policy of the United States."[18] This is especially true where, as in *Fairfield*, the circumstances balance in favor of deference to the foreign main proceeding – the BVI has a much closer connection to the sale than does the United States; claimants will present their claims and receive distributions from the BVI estate not the U.S. ancillary case; the court in the BVI Proceeding has already heard arguments and evidence concerning, and issued its opinion approving, the sale; and the seller is clearly attempting to use the U.S. courts to obtain a "second bite at the apple."[19]

Conclusion

Perhaps the Second Circuit's opinion in *Fairfield* can be limited to cases where the foreign court eschews deference, as perceived in *Fairfield*. However, it may be read to require Chapter 11-type 363 review of any sale of assets within the territorial jurisdiction of the United States by a foreign representative of a foreign main proceeding without regard to principles of comity and without giving deference to the properly adjudicated decision of a court in the foreign main proceeding. As Judge Lifland (who participated in the development and drafting of Chapter 15) stated in the Bankruptcy Court decision below, such a holding will undoubtedly reduce "predictability in the handling of cross-border insolvency cases" and "is a disincentive . . . cross border investment, which is exactly the outcome Chapter 15 was designed to prevent."[20] Nothing in Bankruptcy Code Section 1520(a)(2) prohibits application of the principles of comity – which are at the core of Chapter 15 – or dictates that standards other than comity must apply to asset sales within the territorial jurisdiction of the United States. ■

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[1] On October 17, 2014, the authors of this article, Daniel M. Glosband and Kizzy L. Jarashow, published a companion piece in Law 360 titled "*2d Circ. Fails To See The Comity In Chapter 15*".

[2] 11 U.S.C. § 1520(b).

[3] *See* House Report 109-31, pt. 1, 109th Cong., 1st Sess. (2005) at 115.

[4] In the alternative, Farnum asked that the panel opinion be amended to make clear that certain alternative arguments (other than comity) made by Farnum in both the lower courts and before the Second Circuit – which could "foreclose the need for any section 363 review" – remain open on remand. *See* Petition for Rehearing at 15. The Second Circuit has since directed Krys to respond to Farnum's contention that the court's opinion should be modified to permit the District Court, on remand, to consider the alternative arguments that might preclude the need for the Section 363 hearing (the "Alternative Arguments Order"). *See* Alternative Arguments Order at 1 (Case No. 13-3000-BK, 2d Cir. Nov. 3, 2014) [D.I. No. 98].

[5] References in the trade confirmation are to approval of the settlement agreement with the Madoff Trustee and to approval of the "assignment of the claim by Seller (Madoff Trustee) to Buyer (Farnum)." *See Fairfield*, Joint Appendix at 53.

[6] *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 618 (Bankr. S.D.N.Y. 2013).

[7] *Id.* at 628.

[8] *Krys v. Farnum Place, LLC (In re Fairfield Sentry Ltd.)*, No. 13 Civ. 1524 (AKH) at 1, 2 (S.D.N.Y. July 3, 2013) [ECF No. 15] (holding that the Bankruptcy Court's denial to perform Section 363 was proper, even if Section 363 applies, because the BVI court, "with primary jurisdiction over the debtor's bankruptcy—observed that the deal 'was negotiated at arms [sic] length by sophisticated parties with full awareness of the market' and . . . concluded that 'the fact . . . that the market has risen since the transaction closed is irrelevant.'").

[9] 11 U.S.C. § 1502(8) (emphasis added).

[10] *See* N.Y. C.P.L.R. §§ 5201(b), 6202.

[11] *See In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir.1983) (requiring the court to find a "good business reason" for the sale).

[12] "The Second Circuit has 'repeatedly noted the importance of extending comity to foreign bankruptcy proceedings.'" *Duff & Phelps, LLC v. Vitro S.A.B. de C.V.*, No. 13 Civ. 3242 (PAE), 2014 WL 239802, at *6 (S.D.N.Y Jan. 21, 2014) (quoting *Finanz AG Zurich v. Banco Economico S.A.*, 192 F.3d 240, 246 (2d Cir. 1999)).

[13] *See In re Elpida Memory, Inc.*, No. 12-10947, 2012 WL 6090194, at *8-9 (Bankr. D. Del. Nov. 20, 2012) (while recognizing "the importance of comity, especially in the context of Chapter 15," holding that it must review a "motion *de novo* as it relates to assets in the United States and, in so doing, must apply the well-settled standard governing a sale of assets under section 363 of the Bankruptcy Code.").

[14] *Id.*

[15] "In interpreting this chapter [15], the court shall consider its international origin, and the need to promote an application of this chapter that is consistent with the application of similar statutes adopted by foreign jurisdictions." 11 U.S.C. § 1508.

[16] *Fairfield Sentry*, 484 B.R. at 627.

[17] *Maxwell*, 93 F.3d at 1047-48 (holding that a court in a Chapter 15 ancillary proceeding should not "read general words without regard to the limitations customarily observed by nations upon the exercise of their power").

[18] *Finanz AG Zurich*, 192 F.3d at 246.

[19] *See Fairfield Sentry*, 484 B.R. at 627-28.

[20] *Id.* at 628.

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